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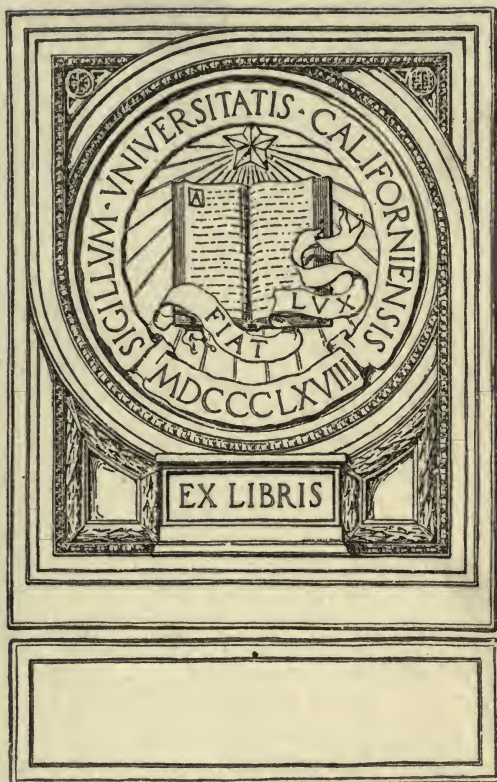
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# GUIDE TO THE STUDY OF AUDITING

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SAMUEL F. RACINE

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College 2

Accounting Students' Series

# Guide to the Study of Auditing

By

SAMUEL F. RACINE

Certified Public Accountant

1914

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# AUDITING THEORY AND PRACTICE

By  
Robert H. Montgomery, C. P. A.

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# AUDITING THEORY AND PRACTICE--

## Montgomery

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### CHAPTER I.

#### PURPOSE OF THIS BOOK.

1. What constitutes a scientific system of accounts?
2. Into what branches may accountancy be divided?
3. Outline the salient features of the report on the financial condition of "A" and "B" Co.
5. Outline the working of the subsidiary plant ledger mentioned. In what way is it like the general books? What is the usual tendency of insolvent concerns in regard to the valuation of assets? Why is it desirable to show the provision for depreciation separate from the machinery account? How is conservatism in valuations supposed to affect the borrowing power of a concern?

### CHAPTER II.

#### PURPOSES AND ADVANTAGES OF AN AUDIT.

8. How do you account for the failure of so many persons to employ auditors?
9. What are the purposes of an audit?
11. What is the responsibility of an auditor in connection with the detection of fraud? What are the principal avenues of fraud? How may fraud be practiced by the mis-appropriation of cash or goods?
12. Explain how accounts may be manipulated to benefit an employee of a concern or to deceive bankers,

creditors or stockholders. What particular types of errors should the auditor watch for?

13. What are the most common errors from principle?

14. How may they be detected?

15. Is it advisable for an auditor to devote his time to the location of clerical errors? What constitutes an error of omission? Do such errors affect the trial balance? What are the most common ones and how should an auditor proceed to locate them?

16. What constitutes an error of commission? What constitutes an "offsetting error"?

18. Outline the advantages of an audit and the advantages accruing through an accurate statement of the condition of a firm.

19. Wherein does a banker profit by certified statements?

20. What advantage accrues to partners through an audit by a C. P. A.? What are the usual disturbances of a partnership? How would you proceed to determine the value of a stock destroyed by fire?

21. How may the interests of stockholders be protected?

22. In the case of public service corporations, what is the usual result of secrecy in connection with earnings? Do certified statements extending over three or four years facilitate in any way the sale of a business?

### CHAPTER III.

#### AUDITOR'S QUALIFICATIONS.

24. How extensive should be an auditor's knowledge of bookkeeping?

25. To what extent should he study text books and professional papers?

26. What are the relative merits of reading and meditation, and practice and observation?
27. What special qualifications should he possess?
29. What should be an auditor's education?

## CHAPTER IV.

### DUTIES OF AN AUDITOR.

34. What are the duties of an auditor?
35. What is said of amateur auditors?
36. What is said of official auditors?
37. What is a "staff" auditor?
38. What is a professional auditor and what is his liability?
40. Outline the duties of an auditor in connection with the audit of a partnership.
41. Of what importance is the partnership agreement? Why should each of the following be mentioned:
  - (a) Nature of business;
  - (b) Capital;
  - (c) Changes in capital;
  - (d) Interest on capital;
  - (e) Withdrawals;
  - (f) Undrawn profits;
  - (g) Interest on loans or withdrawals;
  - (h) Distribution of profits or losses;
  - (i) Approval of accounts;
  - (j) Salaries of partners;
  - (k) Dissolution;
  - (l) Causes for dissolution;
  - (m) Settlement after dissolution;
  - (n) System of accounts;
  - (o) Disputes about accounts;

- (p) Firm insurance;
- (q) How to avoid litigation?

44. In your estimation, to what degree should an auditor advise his clients? Who usually appoints the auditors of a corporation?

47. How may an auditor prove of value to a director or officer in connection with the responsibility of the position of the latter? To whom should he report?

48. To what extent may an auditor criticize an officer of a company?

50. Is it desirable that the accountant when acting as an expert witness have his own papers and records available?

52. May an auditor disclose any information unfavorable to the client? Should an auditor express his opinions before a court?

53. Mention the advantages or objections to auditing eleemosynary corporations.

## CHAPTER V.

### ETHICAL DUTIES—LEGISLATION.

58. Along what lines can the most good be accomplished through the Legislatures?

60. Is it desirable that full reports be given stockholders?

61. What should a balance sheet of a corporation contain?

64. Mention the principal features of the English Companies Act.



## CHAPTER VI.

## HOW TO BEGIN AN AUDIT.

66. Suggest a preliminary program for an audit. Why is it desirable to fix the legal responsibility of the client? Outline the advantages of a thorough understanding before starting an audit.

67. Should overtures be made to secure the co-operation of the client's staff? Should the auditor endeavor to instruct the client's staff, and if so, how?

68. Is it desirable to allow it to appear that the auditor's purpose in connection with a particular audit is the detection of fraud? To what extent should an auditor criticize his client's staff or any member of it?

70. Which is preferable, a per diem rate or a stated fee? Why?

72. Under what circumstances may an auditor accept work, the compensation for which is based on a contingency?

73. In agreeing to make an audit, should any mention be made as to the place where the audit is to be conducted? Why?

74. State what supplies are necessary to start an audit.

77. What should be done with the working papers?

78. Of what value is a list of the books to be used in an audit?

79. Should an auditor inquire into the work of his predecessor?

80. What, if anything, in the methods of conducting the accounts, would lead you to reduce the scope of your audit? What is a detailed audit? Of what value is an audit which consists, only, of a verification of cash payments and the trial balance?

82. How would the existence of an audit staff affect the scope of your audit?

83. How should cash be treated under a system of internal check? Should the cashier be allowed access to ledgers or statements to customers? Why?

84. What is the purpose of, and how should vouchers be used under a system of internal check? Should a copy of all invoices to customers be retained and rechecked? Why? Discuss the manner of treating customers' accounts. What is necessary in a system of internal check regarding the treatment of:

(a) Inventories; (b) Collections; (c) Incoming mail; (d) Pay rolls?

85. What records should an auditor require before commencing an audit?

## CHAPTER VII.

### BALANCE SHEET AUDIT—ASSETS.

87. State the general principles of a balance sheet audit. What are the limitations of a balance sheet audit? Is it proof against fraud? Why?

88. Should a book entry covering the acquisition of a fixed asset be verified in a balance sheet audit? Mention the synonyms of "Current Assets." Are the changes that may occur in the value of items in the accounts, between the date of the closing of the books and the date of the performance of the audit, of importance? Why?

89. Of what value are insurance policies in determining the existence of liens or encumbrances? Is the proportion of current assets to liabilities and capital of importance? Why?

90. What may a capital approximating the amount of sales indicate?



91. When should the cash be verified? May a bank pass-book be accepted as conclusive evidence? Why? What is the usual procedure in making certain of bank balances?

92. To what extent is the average cash balance of interest to the auditor? Would you consider it necessary to inquire extensively into a petty cash balance of say \$400.00 or \$500.00? Why? Under what conditions is it desirable to make a second count of the cash on hand?

93. Should an auditor feel called upon to report on a cash memorandum of an amount less than a week's salary signed by the cashier?

94. Explain why it is desirable to verify all cash balances simultaneously? How should consigned goods be treated?

95. Under what conditions would a compilation of percentages covering gross and net figures of various lines of business be of value to a professional auditor? What inference would you draw from an account which showed a partial payment on an old invoice and complete payments on invoices of later date? How would you treat accounts receivable in your report? What constitutes an "account stated"? If any entries would appear in the books to record the assignment of accounts to a banker, state them.

96. How would you proceed to value overdue trade accounts? Do you believe that a reserve for cash discount should be placed on the books? Give reasons.

97. What is said of rents receivable?

(See "Accounting Principles.")

98. What may properly be included under the caption "accounts receivable"? Explain how you would deal with advances on contracts of purchase.

99. Outline the treatment of "Deposit to secure a Lease."

100. How would you verify the accounts receivable?

## CHAPTER VIII.

### BALANCE SHEET AUDIT—CURRENT ASSETS (Continued).

101. How should notes receivable under discount be shown in the balance sheet? Is anything gained by transferring overdue notes to the account of the customer? (See "Accounting Principles.")

102. Upon which would suit be made, the account or the overdue note? How would the matter of suit affect the desirability of transferring the note? Under what conditions may overdue notes be considered as of equal value to those not due?

103. Outline the treatment of notes received on stock subscriptions. What entries are usually made where goods are sold and the contracts are payable in installments? How should installment sales be treated for balance sheet purposes?

104. What may properly be included under the caption raw material?" Do you agree with the author in the assertion that the inventory value of goods should be changed from time to time under certain conditions? Is a banker justified in presuming that the values mentioned in a balance sheet represent actual current worth? Is it desirable that a profit be anticipated on account of a rising market? Why? What procedure is desirable in case a portion of the stock has deteriorated? (See "Accounting Principles.")

105. Should special consideration be given large items which appear in the inventory? Why?

106. Discuss the question of stock taking and the liability and duties of auditors in that connection.

107. Why is it desirable to secure the original pencil copy of the inventory? To what extent is it desirable to test the accuracy of any of the items mentioned in an inventory? Under what conditions is it considered proper to accept as authentic an inventory taken from the stores-record?

108. Why should the possibility of post-dated invoices interest the auditor? To what extent need an inquiry be made into the purchase of the articles included in the inventory? May duty and freight be properly included in the cost of goods?

109. What is the "gross profit test" and under what conditions is its use possible? What information would an auditor possibly secure by a comparison of the unit inventory price with the unit selling price of a particular product?

110. How would you proceed to value goods in process? (See "Accounting Principles.") Is the tendency to overstate inventories peculiar to any particular class of business?

111. May administrative and selling expenses properly be included in the inventory as a portion of the cost of goods manufactured on contract? How should finished goods be valued? What are the objections to the plan of inventorying finished goods at selling price less a percentage to represent the profit on the sale or, as is sometimes the case, less an amount to represent the expense of delivery?

112. May rent and interest be included in the cost of goods manufactured, when inventorying? Explain the manner of dealing with goods, the selling price of which is below the actual cost. Define turnover and

explain its importance in an audit. (See "Accounting Principles.")

113. Explain the manner of treating supplies and also the reason why they require a treatment different from material in inventories. How would you show an account representing the controlling interest in another company in the balance sheet of the holding company, viz., as a current or a fixed asset?

114. Would the treatment of stock held as an investment be different from that of stock held to control a subsidiary organization? How should securities be valued? Need any consideration be given the unmatured coupons? Is an auditor justified in attempting to value securities and similar investments? What value attaches to a record of serial numbers of securities, in connection with the detection of fraud? What precaution should be taken to assure the actual existence and verification of all bonds?

115. Is it desirable to apply a different rule in the valuation of cash or quick investments than would be proper in the case of more permanent ones? Why? How would the auditor proceed to test the availability of this class of securities?

116. What consideration do stamps require?

## CHAPTER IX.

### BALANCE SHEET AUDIT—FIXED ASSETS.

117. Define "fixed assets." How should they be valued?

119. Outline the auditor's duty and responsibility in connection with their valuation. Under what condition may their "scrap value" be used? Does real estate require any particular attention, and if so, what?



120. Should the author attempt a personal examination of the title to the property? Should any attempt be made to sub-divide the real estate holdings of a company? Would the fact that the concern under audit is a real estate concern influence your treatment of this item? State the treatment of land in the accounts. Need it be reduced on the books if an unfavorable fluctuation has occurred? Why?

121. Should a distinction be made between improved or unimproved land? Give reasons. Is the treatment of "carrying charges" properly dealt with in this chapter? In answering, give consideration to the rule that all expenses incurred during the period of incipency of an undertaking may properly be capitalized. Need an auditor call attention to an increase in the book value of land made in giving effect to a favorable fluctuation? Why?

122. For what reason is it undesirable even to assume an increase in the value of land which constitutes a portion of the plant of an undertaking, even though surrounding property is undoubtedly worth much more? Outline the manner of treating the account representing buildings, in the books? Does the fact that the plant might be upon leased ground require consideration? If so, how may this feature affect the treatment of the accounts?

123. If the lease has increased in value to the extent that it is worth much more than the building situated upon the land, need depreciation be written off?

124. Would the fact that the purchase price of the lease is in excess of its real value and that the annual charge to revenue on account of its amortization is in excess of the amount that like premises can be rented for, necessitate the writing down of the lease account

to its actual value? How should machinery and equipment be valued? Define obsolescence. Of what value is a plant ledger to the auditor?

125. Explain the theory that the usual charges for depreciation are excessive. How would you treat discarded machinery?

126. How should small tools be treated? Discuss the treatment of fixtures, giving consideration to those on leased property as well as their physical condition. Discuss the treatment of packages returnable, also of deposits that may have been made thereon.

127. Upon what basis should depreciation be written off horses or how should the account be treated? What is a satisfactory rate of depreciation on automobiles? Discuss the treatment of patterns, drawings, etc., in the accounts.

128. How should plates of a book be valued?

129. Discuss the valuation of patents. What conditions tend to decrease the value of patents other than expiration of life? (See "Accounting Principles.")

130. Wherein does the treatment of copyrights differ from that of patents?

## CHAPTER X.

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### BALANCE SHEET AUDIT—FIXED ASSETS (Continued).

131. Is depreciation applicable to goodwill? Discuss the advisability of decreasing or increasing the value of goodwill. What is the effect of writing off goodwill? (See "Accounting Principles.")

132. Mention a few of the elements of business which constitute goodwill.

135. Endeavor to explain just what goodwill represents. Is the term "fund" ever properly used on the credit side of a balance sheet? What is the usual pur-

pose of a sinking fund? (See "Accounting Principles.")

136. To what extent should an auditor verify the existence of sinking fund assets? Mention a few items that may properly be included under the caption "Fund and other Permanent Investments." State the difference in the treatment of permanent and temporary investments in the inventory. Explain fully the treatment of bond investments in the accounts.

137. Why is it desirable to mention, also, the market values of bonds, where the plan of amortization is used in determining their value for balance sheet purposes?

138. To what extent is the auditor interested in the terms of the various mortgages or trust deeds that may have been issued by the company under audit? In the case of the sale of obsolete property which is included in the security mentioned in a mortgage, what disposition should be made with the cash received for it? What constitutes treasury stock and how should it appear in the balance sheet under various conditions?

139. Explain the usual method of entering capital stock of a company on the books, presuming that a portion has been subscribed and issued and that some of it still remains unissued. Is timber a fixed or a current asset? In dealing with the valuation of a mine or timber do the rules of depreciation apply or is it a case of inventory value? (See "Wasting Assets," "Accounting Principles.") May dividends be paid out of capital in the case of a company operating a wasting asset? What bearing do the by-laws of a company have on the validity of a dividend where the capital of such a company is being distributed?

140. State the proper procedure of an auditor verifying the mines account. How is the value of timber

ascertained? What are contingent assets? If the corporation audited is a double liability corporation, should mention be made of the fact?

141. What consideration should be given to calls in arrears? Need any consideration be given the possibility that the directors may be liable? Why? Define "Secret Reserves" and explain how they are created. (See "Accounting Principles.")

143. What action should an auditor take where an inventory is deliberately reduced to an improper sum?

144. How does the deliberate writing down of asset values affect the minority stockholder? How should the profit and loss account be prepared where it is desired that the stockholders will not be misled by excessive charges to it, made with a view of creating a secret reserve? What appears to be the proper treatment of bank fixtures and buildings in the accounts?

146. Is it ever proper to omit an asset from the books? Why?

## CHAPTER XI.

### BALANCE SHEET AUDIT—LIABILITIES.

148. What is the most important duty of an auditor in respect to the liabilities of the concern under audit? What consideration should be given contracts covering the purchase of goods?

149. Outline the auditor's duty in regard to accounts payable.

153. Discuss the treatment of cash discounts. How should sales of consigned goods be treated?

154. How should notes payable be divided?



155. What particular points require attention in connection with the verification of notes payable? Discuss the treatment of mortgages in an audit.

157. Does the interest that accrues on a bond become an additional lien on the security? Does an increased period of life of a bond issue necessarily decrease the value? Why? Do judgments require special consideration?

158. Is interest payable a current or a fixed liability?

159. Is a reserve for taxes essential? Why? What is the procedure in determining the liability for accrued wages?

160. Discuss the treatment of an existing liability for freight. What procedure is necessary in connection with amounts due salesmen? Is it necessary to set up a reserve to cover audit expense?

161. What consideration do damage claims require? Outline the usual treatment of car tickets, coupons, etc.

162. Explain the usual treatment of deposits made by consumers to a gas company to protect the company. Discuss the treatment of "Deposits of Employees."

163. What is the proper treatment of dividends in the accounts?

## CHAPTER XII.

### BALANCE SHEET AUDIT—CONTINGENT LIABILITIES AND CAPITAL.

165. What is a contingent liability?

166. Should a reserve for bad debts include an amount to protect the loss through bad notes? (See "Accounting Principles.") Outline the treatment of

notes in the accounts, giving consideration to their acceptance, hypothecation and payment. Discuss "indorsements."

167. In the case of an accommodation indorsement, what entries, if any, would you find on the books and what would be their comparative value?

168. How do investments in other companies often influence the financial standing of a concern?

169. Under what conditions, if any, is it desirable to mention "Guarantees" in the accounts?

170. Do unfilled contracts affect the financial condition of a concern, presuming that goods are to be received of an amount equal to the liability that is to be placed on the books at the time the goods arrive?

171. Of what value is the minute book to an auditor? Is an auditor justified in mentioning his inability to inspect the minute book, in his report? What information may be disclosed by an inspection of the minute book?

172. What are reserves?

174. For the purpose of comparison, cite the views of other authors in connection with reserve accounts and reserve funds and explain where Mr. Montgomery differs. (See "Accounting Principles.")

175. Should special attention be given the presentation of the proprietary interest in the concern when preparing a balance sheet? Why?

176. Mention the duties of an auditor in regard to the capital stock and also the features that will require particular attention.

177. What account should be credited with premiums received on an issue of stock and what should ultimately be done with the account? (See "Accounting Principles.") How should a reserve for depreciation appear in the books? Where sinking funds are

operated in connection with obligations on mines, etc., and where they agree in amount with the depletion of the property, need provision be made for depreciation or depletion? (See "Income on Reserve Investments"—"Accounting Principles.")

178. Explain the use and purpose of a reserve for exhaustion account. Under a condition in which sinking fund requirements provide for the setting aside of a sum greatly in excess of the proper charge for depletion, how would you provide for the proper display of information as to earnings in the profit and loss account? Of what should a reserve for working capital consist and what is its purpose?

179. How should dividends on cumulative preferred stock which are in arrears appear in the balance sheet? What book entry, if any, should be made? (See "Accounting Principles.") Where should "Surplus" appear in the balance sheet?

180. Should the use of the term "Surplus" be restricted to represent sums properly available for dividends?

## CHAPTER XIII.

### PROFIT AND LOSS ACCOUNT.

182. Define "Net Profit."

186. What items should be deducted, or excluded, from gross earnings? Under what condition may rebates and allowances be included in the sales account and the net amount only shown? Where should a reserve for bad debts be shown in a profit and loss account? Where should the account appear in the balance sheet?

187. May a profit be assumed on work in progress and if so, under what conditions?

189. How should departmental profits be treated?

190. How should the profits of a subsidiary company on inter-company transactions be treated in the reports of a holding company?

192. Discuss the treatment of sales for future delivery and the advisability of, or objections to, assuming a profit in advance of actual delivery.

193. May a profit be assumed on underwriting transactions in advance of the closing of the syndicate? Is the profit on the sale of a fixed asset properly available for dividends? Outline a desirable manner of treating such profits in the books. May an appreciation in the value of a fixed asset be credited to surplus account and later declared as a dividend?

194. What are the objections to placing the appraised value of a plant on the books? What is the effect of such an act on the future net profits of the concern, presuming that at the time of the appraisal the asset accounts were considerably increased on the books?

## CHAPTER XIV.

### PROFIT AND LOSS ACCOUNT (Continued).

197. What is said about depreciation and obsolescence?

199. Is obsolescence a charge against operations or against net profits?

200. Does the fact that it is difficult to determine the amount of the reserve for obsolescence eliminate the necessity of the reserve or the placing of the charge in the profit and loss account? How should "Accrued Expenses" overlooked in a particular year be treated in the profit and loss account of the succeeding year? (See "Profit and Loss Adjustments"—"Accounting Principles.")



201. Are cash discounts an expense of the business or is the account a deduction from sales? (See "Accounting Principles.") Do trade discounts properly appear in the books?

202. The amount of net profit having been determined upon, what is the proper procedure in disposing of the amount? What is said about retaining in the company the profits which are available for dividends?

203. Of what value is an accurate determination of what is chargeable to capital and what is chargeable to revenue? Discuss the declaration of dividends in connection with the following businesses, each operating a wasting asset:

- (a) Mining company;
- (b) Steel company operating a subsidiary mining company;
- (c) Life tenant of an estate.

206. Discuss the apportionment of interest and dividends in the case of a decedent's estate. What is said in reference to extraordinary dividends?

## CHAPTER XV.

### CERTIFICATES AND REPORTS.

207. What is said of the object of the audit?

208. What does the banker expect of an auditor's report? Is it desirable to submit a supplementary report to the bankers?

209. Outline the scope of the report. Should the auditor outline the work done in the audit when preparing a report?

210. How does the purpose of an audit affect the report? What should the certificate of audit include?

211. State the procedure where, owing to the period that has elapsed or for other reasons, it is impossible to certify that the balance sheet agrees with the books.

212. Explain the difference between the American and English balance sheet forms and give the reasons advanced for their use.

213. Explain what is meant by the account form of balance sheet.

214. What information should an ideal balance sheet set forth? In what order should the assets appear? In what order should the liabilities appear? How should deferred charges to operations appear in a balance sheet? Where should the item "Goodwill" be placed? What class of reserves may properly be included under the heading "Reserves" if the item is placed as shown in the form on page 214? (See "Accounting Principles.")

215. What are the objections to the form most generally used by large industrial corporations? Discuss the advantages or disadvantages that accrue through placing the capital stock first and the surplus last in a balance sheet. What advantages are possessed by the account form that are not possessed by the statement form of balance sheet?

216. What is to be gained from the study of how to place the various groups of items?

217. Compare the Standard Form of Borrowers Statement with the form on page 214 and point out the differences, explaining the reasons therefor.

218. Compare the forms on pages 217 and 220 and point out their relative advantages.

222. Criticize the arrangement of the assets in the form on page 222. Explain, if possible, the advantages of separating the liabilities as shown in

this form. Do you believe that for most concerns an accurate distribution of liabilities could be made under the various headings mentioned? What could be the object of the question, "Is the surplus at the risk of the business"?

223. State the purpose of the last question on page 223. Discuss the relative merits of the two forms shown on pages 222 and 223.

## CHAPTER XVI.

### CERTIFICATES AND REPORTS.

226. Mention a few of the advantages of this form for the purpose it is intended.

227. Discuss liens and hypothecations in connection with an audit.

228. To what extent is an auditor responsible where he has not discovered evidence of a lien?

229. Will the item "Net Profits from Operations" be truly stated if the item "Other Earnings" is added to "Gross Profits"? Do you believe the item "Extraordinary Profits" should be stated separately from "Surplus for the Year"; or should the surplus contain the extraordinary items; or would it be preferable to modify the item "Surplus for the Year" in some way? Give reasons.

230. In addition to the statement of profits or losses, what information may properly be included in a profit and loss account? To what extent may an auditor use information secured from the accounts of his clients?

231. What advantages attach to the use of charts? How may the results of comparative years be shown?

232. How may the same chart be used to contain information of various classes, some of which are computed on a different unit than others?

233. Prepare a chart based on the following figures:

	Sales	Cost & Exp.	Net Profit
January .....	18000	17200	800
February .....	19500	18400	1100
March .....	22000	20250	1750
April .....	21500	19900	1600
May .....	20000	18750	1250
June .....	16000	15750	250
July .....	15000	15000	.....
August .....	15300	15200	100
September .....	15600	15450	150
October .....	17700	17000	700
November .....	18600	17700	900
December .....	21000	19500	1500

234. Explain the advantage of a "sales and purchase chart." Draw a chart showing sales and purchases based upon the following information:

	Sales	Purchases
January .....	170,000	160,000
February .....	180,000	162,500
March .....	180,000	165,000
April .....	187,000	172,500
May ....	196,000	174,000
June .....	193,000	176,000
July .....	192,000	180,000
August .....	190,000	182,000
September .....	187,000	185,000
October .....	186,000	185,000
November .....	187,500	195,000
December .....	192,500	200,000



(a) Draw the perpendicular lines  $\frac{1}{8}$ -inch apart and the horizontal lines  $\frac{3}{8}$ -inch apart and let the lower line represent the unit 150,000.

(b) Prepare a chart containing the same information as before but have all the parallel lines  $\frac{3}{8}$ -inch apart and allow the lower line to represent zero. In the two charts just prepared point out by a comparison of relative distances the defects in the information conveyed. (See Dicksee's "Advanced Accounting.")

236. How may a study of comparative statistics act as a preventive of fraud?

238. What are the advantages of including a list of accounts receivable in a report? Of what value is an investigation of outstanding unpaid bank checks?

239. How far may an auditor restrict the use of his report or portions thereof?

## CHAPTER XVII.

### THE DETAILED AUDIT—GENERAL PRINCIPLES.

241. Distinguish between a completed and a continuous audit. Mention a few of the advantages of a continuous audit.

242. How do you account for the preference given the completed audit?

243. State the purpose and limitations of an audit note book.

247. State the general principles which govern procedure in the detailed audit of income and expenses.

248. Is an auditor justified in proving all footings and postings? If fraud exists with respect to purchase, where is it likely to be found?

249. Outline the procedure in testing the purchase ledger.

251. How would you proceed to detect fraud in the accounts receivable?

252. What attention, if any, should be given the reconciliation of bank balances?

254. Outline a desirable plan for handling cash receipts. How may cash payments be fraudulently manipulated?

256. To what extent should an auditor verify the accounts payable.

257. Mention a few of the advantages derived from the use of a considerable number of books with appropriate names.

## CHAPTER XVIII.

### THE DETAILED AUDIT (Continued)—VERIFICATION OF INCOME.

259. What steps should an auditor take in verifying sales? Mention a few of the advantages of inspecting memorandum books in connection with the detection of fraud.

260. What procedure should an auditor take to detect fraud in the records of a lumber company which ships many cars of lumber to all parts of the United States, much of which is billed to jobbers rather than to the consignee? Give consideration to the possibility of the yard foreman working in collusion with a jobbing concern, located in a different city, of which he is the principal stockholder. Of what value is a balance sheet in tracing fraud?

261. How should cash discounts be treated in the cash books? (See "Accounting Principles.")

262. Explain the operation of the lapping system of covering cash defalcations and give the procedure of an auditor in its detection.

264. Explain the manner of verifying the accounts receivable.

265. What is the proper method of auditing investments?

266. Outline a desirable plan of treating investments in the books.

267. What consideration does interest receivable require? What is said about trade discounts?

268. How should real estate holdings be treated in the accounts? What consideration does rents receivable require on the part of the auditor?

269. To what extent is an auditor justified in making an inquiry into the possible realization from accounts previously charged to profit and loss? How should consigned goods be treated in the books and at the time of balancing? (See "Accounting Principles.")

270. What is the auditor's duty in regard to goods received for sale?

271. Why do the insurance policies require attention?

272. Is it permissible to include any portion of the profit anticipated on a sale, the goods for which are still in process of manufacture? What portion of the expenses attached or traceable to sales not delivered, may be treated as deferred charges to operation?

273. Outline the procedure in verifying the records of sales of lots by a real estate company, which is selling some particular addition.

## CHAPTER XIX.

THE DETAILED AUDIT (Continued)—PURCHASES  
AND EXPENSES.

274. Of what value are vouchers to the auditor?

275. Of what value is a paid check as evidence of the propriety of a payment?

276. What is the auditor's duty in regard to purchase invoices?

278. Should the auditor notice the names to whom the purchases are charged? As an example, assume the case of a limited liability company that is in financial difficulties to an extent that some of the creditors are billing to the directors of the company instead of to the company itself. Do the dates of invoices require consideration? Why? What attention should be given missing vouchers?

279. Outline fully a proper system of paying small cash items and explain the manner in which they should be audited.

281. What treatment should be given organization expenditures and expenditures of one year which are presumed to have been made with a view of increasing the following year's profit? (See "Accounting Principles.")

282. Is the expense of establishing a branch office a proper charge against operations?

283. How should extraordinary expenditures be treated?

284. Which is preferable and more liable to be placed on the books without opposition; a direct charge or a reserve for repairs and renewals?

285. State the proper treatment of returns and allowances and the auditor's duty in connection therewith.



286. Discuss the treatment of "Empties."

287. What attention should an auditor give wages and salaries and what methods of handling should he recommend?

288. How should accounts with salesmen be treated? In answering this question give consideration to commission, travelling expense, mileage, advances, and cash. How would you proceed to prove the accuracy of the payments made in settlement of wages?

290. Do the amounts paid for duty require any special attention on the part of an auditor? If so, what?

291. Discuss the treatment of insurance.

292. Do paid freight bills require any special attention? What attention should be given the postage account?

294. How should returned purchases be treated?

## CHAPTER XX.

### THE DETAILED AUDIT (Continued)—THE TRIAL BALANCE.

296. Is it the auditor's duty to locate errors in a trial balance?

297. What is said about outstanding accounts? What consideration should the auditor give old balances appearing in a current account with a customer? Outline the most desirable method of treating overdue accounts receivable.

299. What consideration should be given notes receivable? Which is preferable, charging a protested note to the personal account of the debtor with the protest fees included, or charging the bills receivable

account with the protest fees and keeping both in that account? In answering this question give consideration to the proper manner of collecting through the courts, i. e., by an action on the note or on the account, also the possibility of a note becoming lost or mislaid if it is not represented in the bills receivable account. (See "Accounting Principles.") Of what importance is a careful examination and comparison of the inventory at the beginning of the period and the one at the end of the period?

300. Explain the manner of treating premiums and discounts on bonds sold. How should premium received on an issue of capital stock be treated? (See "Accounting Principles.") May this premium be returned to the stockholders as a dividend?

301. Mention the principal points in the audit of a branch office or of a number of them.

302. Of what importance is the careful distinction between capital and revenue expenditures? What is the most practical manner of determining just what amounts may be properly charged to capital?

303. What treatment would you suggest for a series of expenditures extending over a period of say six months, all relating to the construction of a particular building, it being undesirable to charge items to capital accounts unless they represent some particular addition to the owner's property? Assume a purchase of machinery billed at \$5,000.00, terms 2%—10 days and paid for within the discount period. Upon what amount would depreciation be computed, \$5,000.00 or \$4,900.00? Is it proper to allow the availability of money at the time of purchase to affect future charges for the use of the property that is being consumed through operations?

304. Is a concern justified in assuming a profit

on the construction of one of their buildings by their own force, when it would have cost more had it been done by others? (See "Accounting Principles.")

305. May freight, labor, etc., be included in the capitalized value of machinery? What consideration is required in connection with notes payable and how should they be handled? What suggestions can you make in regard to partner's withdrawals? May dividends be declared of a past date?

306. May the directors be compelled to pay dividends? In the apportionment of a decedent's estate, is a stock dividend corpus or income?

307. What consideration, if any, do the stock ledger and stock certificates require? What is said about bonds and coupons and their treatment when cancelled?

308. Should a reserve be set aside to provide for the Federal corporation tax? State the auditor's duty in connection with office systems.

309. What are the essentials of a desirable filing system?

311. Suggest a few features of a desirable system for handling stores.

313. How would you proceed to test the accuracy of stock? Does any advantage accrue from keeping the sales, purchases and inventories of various classes of goods separate?

314. Explain the purposes and mention the advantages of controlling accounts. Mention a few of the advantages possessed by columnar ledgers.

315. To what extent may an auditor criticize the efficiency of an organization?

## CHAPTER XXI.

## DEPRECIATION.

317. Distinguish between fluctuation and depreciation. Define depreciation.

318. Should the allowances for depreciation vary in different years?

319. Mention a few of the causes of depreciation.

320. What is said of repairs and maintenance? Explain the various methods of caring for depreciation. (See "Accounting Principles.")

321. What is the effect of the fixed percentage method of charging depreciation:

(a) On a flat basis?

(b) On a reducing scale?

What advantage or disadvantage does the sinking fund method possess?

325. Is a dividend illegal if it requires the entire surplus and if no provision has been made for depreciation? Why? Is a charge for depreciation based on the amount of operating revenue proper?

326. Should interest on a sinking fund be allowed to affect the amount charged against revenue during the life of an asset? (See "Income on Reserve Investments"—"Accounting Principles.") The table given shows exceptionally large charges to revenue during the first years of the existence of the asset in the case of the percentage based on diminishing values. Under what conditions does this plan of allowing for depreciation prove desirable? Is a sum set aside proportionate to production, a reserve for depreciation or a reserve for renewals?

327. What effect does the probable exhaustion of the material upon which to work, have on the rate



of depreciation? Does the existence of a sinking fund operated in connection with a bond issue obviate the necessity of providing for depreciation?

328. Is it desirable to invest the amount of a depreciation reserve and what is the effect of such a procedure?

331. Which is preferable, a reserve for depreciation, a reserve for obsolescence or a reserve for contingencies to provide for obsolescence of machinery? Under what condition does land depreciate?

332. How does the fluctuation of land values affect the charge for depreciation?

333. What is the approximate life of different classes of buildings? Explain the manner of treating premium paid for a lease. Need any consideration be given the possibility of loss from damages to leased property? If so, what? Is the plan of writing off equal portions of the purchase price of a lease each year theoretically correct? Why?

334. What rate and plan of depreciation is usually used in connection with machinery and equipment? Of what advantage is an equipment ledger?

336. What treatment should be given small tools? How should furniture and fixtures be treated in the accounts? What effect does the fact that fixtures are on leased property have on the annual charges for depreciation? What treatment on the books should be accorded horses?

337. What do you believe to be a fair rate of depreciation on automobiles? How would you treat the depreciation on ships? What is the proper method of handling accounts representing patents, giving consideration both to absolute ownership and to leases? May a leased patent be properly placed on

the books in excess of actual cost? Need a different treatment be given copyrights? If so, what?

338. What is a wasting asset? Wherein does the depreciation of mines differ from the depreciation of machinery? (See "Accounting Principles.") Is it necessary to allow for the depletion of a mine? What objections are there to providing for such depletion? How does the limited period of operating, the possibility of working out a section at a time, and the comparative ease of cruising affect the relative treatment of timber lands?

## CHAPTER XXII.

### CORPORATION TAX LAW AND DEPRECIATION.

342. What is the substance and the effect of the decision in the case: *The United States vs. The Nipissing Mines Co.*?

343. Need the depreciation actually be given effect on the books?

344. Upon what is the deduction for depreciation based? How should a fluctuation in the value of real estate be treated?

345. How should the net income on an uncompleted contract be determined? Discuss fully the treatment of minerals, etc., in connection with the corporation tax returns.

## CHAPTER XXIII.

### SPECIAL POINTS IN DIFFERENT CLASSES OF AUDITS— FINANCIAL.

349. What is said in reference to the examination of banks?

352. Mention a few of the principal points in the audit of a bank? How would you proceed to verify the cash and securities?

353. Of what value is a clearing house confirmation? How may the accounts with correspondents be used to conceal fraud? What attention should demand notes receive?

354. How would you verify the certificate of deposit and the certified check accounts? How may stock certificates be used fraudulently? Outline the auditor's procedure in verifying the accounts with depositors.

355. What special attention should be given inactive accounts? What information would you expect to secure by a comparison of the individual deposits in a pass book with the entries in the ledger? Discuss the verification of income.

356. Mention a few of the features of a good system of internal check. What should the auditor's report contain?

357. Outline a few of the most usual plans of covering shortages.

359. What are the general points to be covered in an examination made by a directors' committee, as outlined by the Comptroller of Currency?

360. What are the essential features of a savings bank audit?

361. What privileges are allowed trust companies that are not allowed national banks?

362. Mention a few of the departments conducted by a trust company that are not conducted by a national bank. To what degree should the auditor attempt to check the transactions occurring during the audit period?

363. What items require special attention in the audit of an investment company?

364. What is the accepted rule in determining the net profit of an investment company? To what account should the difference between the market values and cost price of investments be charged if a decrease in value has resulted? How should the account be treated in the balance sheet? If a favorable fluctuation has occurred, how should it be treated? Why is it desirable to distinguish between bona fide investment companies and speculative securities companies?

365. Is it wise to assume a profit where a simple exchange of stock has occurred? Why? What is the meaning of "wash sales"?

366. Mention a few of the books found in a stock broker's office and explain their use.

369. How would you verify the cash or securities? How would the accounts with customers be verified?

370. What attention should be given margins? Is it within the auditor's duty to verify all charges for interest or commission? What constitutes the most satisfactory audit of a broker's accounts?

371. How may dividends be diverted into improper channels? Explain the method employed by the cashier in abstracting cash as mentioned on page 371.

372. Outline the usual plan of organization of a building and loan association; also explain the method of operation. Wherein does the payment of the capital stock of such an association differ from that of an ordinary company?

373. What are the principal sources of income of building and loan associations? How would you proceed to verify the income of the association?



374. How would you proceed to verify the amount of capital stock outstanding?

375. Explain the most desirable plan of apportioning the earnings of the association. Upon what should the profits be distributed—the average book value of each share or the amount of dues paid in?

376. Refer to the form on page 376 and comment on the order of the assets shown. Do the profits of the year properly constitute a portion of the capital stock?

## CHAPTER XXIV.

### SPECIAL POINTS IN DIFFERENT CLASSES OF AUDITS (Continued)—INSURANCE COMPANIES.

378. Under what laws do insurance companies usually incorporate? Who is authorized to audit the accounts of insurance companies and what is the object of such an audit?

379. What are the principal sources of income of a fire insurance company and how would you proceed to verify their receipt? In addition to the verification of the income, what points should be given consideration by the auditor?

380. Explain the manner of manipulating the accounts as employed by Walker and Bradford?

381. Mention a few of the most important liabilities of a fire insurance company and explain how an auditor would proceed to verify them?

382. In what respects does the audit of a life insurance company differ from that of a fire insurance company? What attention should be given the investments of the life insurance company? How should loans to policy holders be verified? Ordinarily may a life insurance company invest in real estate?



Mention other sources of income of a life insurance company and explain the method of verification.

383. How is the insurance reserve of a life insurance company calculated?

384. Is it considered proper to include real estate at its appraised valuation in a balance sheet, and if so, what is the final disposition of the amount by which it is increased or decreased from year to year? What should be contained in the account "Syndicate Subscriptions"?

385. What criticisms can you offer as to the comparative arrangement of the assets and liabilities?

386. Is the item "gain in market values" properly included in the income account without also giving effect to some compensating item to offset its effect until the profit anticipated is actually realized? Is there an account in this statement which contains the offsetting entry and if so, which one?

390. What should be the procedure of the auditor in verifying expenditures for wages? What consideration do freight and material require on the part of the auditor? Explain the different plans of providing for depreciation of manufacturing plants.

391. Under what conditions is it proper to set up a "Reserve for Repairs and Renewals" determined by the production method, and does such a reserve eliminate the necessity of providing a reserve for depreciation? Mention a source of income often found in the accounts of manufacturing companies owning the homes of their employees and explain the manner of verification. How would you recommend that rentals secured through sub-letting a portion of leased premiums be handled? Of what value to the auditor are cost and stock accounts in a manufacturing plant?

392. What is gained by showing the property, acquired during any one year, in an account separate from the account representing property on hand at the beginning of the year? In this balance sheet, for the purpose of comparison and the consideration of relative values are "Goodwill" and "Capital Stock" properly placed? Why? Are the current items properly placed for comparison? Are the items under the caption "Current Assets" arranged in proper order? Why? Should bonds and stock of other companies be included under the caption "Current Assets"? Why? Is it proper to include accrued items under the caption "Current Liabilities," and if so, why should the deferred charges to operation be shown under a separate heading among the assets? What excuse is there for showing "Bonded Debt" first among the liabilities?

393. Wherein does the treatment of capital in the balance sheet differ from the usual American form? Where should contingent liabilities be placed in a balance sheet?

394. Under what conditions, and why, is it desirable to keep the sales account so it will show not only values, but quantities as well? Mention a few of the special features of publishers' accounts and explain how they should be treated by the auditor.

395. How should royalties be handled? Are they an element of cost? To what extent should the auditor inquire into inventories?

396. Discuss the valuation of plates, linotype metal, drawings and electros in connection with the inventories.

397. Do the accounts receivable require special consideration and if so, what? How would you deal with postage?

398. Mention the principal sources of revenue of a magazine or newspaper publisher and explain how the auditor should proceed in their verification.

399. What precaution would you take before certifying to the circulation of a paper?

400. How should subscriptions be handled in the accounts so that each month will show a proper credit for the amount earned?

402. Give a careful outline of the work that should be done by an auditor in verifying brewers' accounts, giving consideration to containers, collections, investments in saloons, advances and contingent liabilities.

403. What advantage would accrue from an inspection of a mine by an auditor who expects to prepare a report on the financial result of its operations? A mining company may receive income from coal sales, blacksmithing, auxiliary stores, rentals of property, and compensation for use of cars. How would you verify these? Discuss the treatment of accounts covering royalties paid in advance to be recouped from future workings. (See Dicksee's "Advanced Accounting.")

404. How should the various assets be valued for inventory purposes?

405. Is it necessary for a company working a wasting asset such as a mine or quarry to provide for the exhaustion of the property? Why? (See "Accounting Principles.") What consideration do mortgages require on the part of the auditor?

406. Give an outline of what your procedure would be in the audit of a gold mining company.

407. Mention a few of the possible frauds in a wholesale grocery and explain how you would proceed to detect them.

408. What details should be included in the trading statements of such a firm? How should an auditor proceed to verify the sales of a retail merchant?

409. Explain how sales to employees should be treated. What plan would you suggest for keeping "tab" on stock?

410. Do credit memoranda require special consideration, and if so, how would you recommend that they be treated?

411. What is the auditor's duty in regard to cash discounts in a department store? How would you verify the payrolls and other items of expense in a department store?

412. Outline a desirable and practicable plan of accounts showing the operations of each department. In the preparation of reports showing the operation of a department store, what information should be disclosed?

413. Explain how you would proceed to value notes and accounts receivable held by a department store. Need any special consideration be given inventories? If so, how would you deal with each special feature? Mention the most important features of the audit of an automobile dealer's accounts and explain how you would deal with each.

416. A firm having several branches maintains an account with each branch in the ledger and charges to such account all goods sent to agents for stock. When stock is taken the balance of each branch account is treated as ordinary accounts receivable and is included in the general debts owing to the firm. If you see any objections to this method, state them and say how you would handle the accounts. Explain how cash should be treated at a



branch office. To what extent should an executive office be informed of the individual transactions of a branch?

417. Assuming that goods are billed to a branch at 20% in excess of cost, what entries should be made on the books of the executive office to remove the excess for the purpose of inventories? Explain how the book values of various assets of foreign branches should be treated to facilitate the preparation of consolidated balance sheets, giving consideration to the treatment of fixed assets, current assets and remittances. (See Dicksee's "Advanced Accounting.")

## CHAPTER XXV.

### SPECIAL POINTS IN DIFFERENT CLASSES OF AUDITS (Continued)—PUBLIC UTILITIES.

418. Give a brief outline of the powers and duties of a Public Service Commission.

420. Discuss the importance of making allowance for depreciation in the accounts of transportation companies. Should a distinction be made between the profit of a public utility from the viewpoint of the general community and the profits earned from the point of view of the stockholders? If so, what differences would exist?

421. What items would you classify as expenses for the purpose of a published statement and how would you arrive at the net earnings? How would you deal with items not directly traceable to the operation of the utility?

422. In the audit of a public utility, how would you determine which expenditures do or do not constitute a proper charge to revenue?



423. In the case of a substitution of one asset for another, what entries should be made on the books of account?

424. Do gross earnings from by-products constitute an item of revenue or are they a reduction of the cost of manufacture? Is there any reason why taxes should not be included in the cost of the product or apportioned under the various subdivisions of Expense? Is the expense of manufacture properly stated if it does not include a charge for insurance and depreciation, or either of them?

425. What should a valuation of the properties of a public utility include?

426. Outline a desirable method of procedure in the appraisal of a public utility.

427. Mention a few items of expense which may properly be capitalized as "Development Charges." How should the discount on bonds sold be treated in the books of a steam railroad?

428. Mention a few of the sources of income of a steam railroad and explain how you would proceed in its verification.

430. What possible technical errors should the auditor guard against?

431. Mention a few of the special features of an audit of the accounts of a shipping company and explain how they should be dealt with.

432. Explain how an insurance fund should be operated and discuss the advisability of carrying forward a deficit in the account from year to year.

433. What is the most accepted classification of the accounts of an electric railway? Mention the principal sources of income of an electric railway and explain how you would proceed to verify them.

434. How would you verify the pay rolls? What advantage accrues from issuing tickets under the serial plan?

435. In the case of a street railway which allows its conductors to sell tickets covering transportation for ten and twenty-five rides at a lower rate than it demands for cash fares, how would you apportion the revenue so received, bearing in mind that at the end of each month many tickets remain unredeemed? Of what value is a record of construction and equipment costs and how should such a record be operated?

436. Suggest a term for use instead of "Depreciation." Combat the argument that a reserve for depreciation is unnecessary owing to a rapidly increasing value of the franchises. Discuss the treatment of so-called reconstruction expenditures, giving consideration to various conditions which affect their disposition.

437. A company has purchased certain properties which are found to be in a run down condition and a considerable expenditure is necessary to bring them into efficient operation. Should such an expenditure be capitalized? What disposition is suggested for expenditures which do not increase earnings nor decrease operation expenses?

438. What should be the auditor's procedure in determining the liability existing on unsettled damage claims? Give a short explanation of the operation of a reserve for accidents.

439. How should an auditor proceed to verify the income of a taxi cab company? What are the salient features of such a verification?

441. The forms given herewith seem to be more free from technical inaccuracies than those usually

published. The student will do well to notice carefully the grouping of the items and their location in the forms. Notice also the additional column provided for comparative purposes and, on pages 442-443, the ease with which the current assets and liabilities may be compared as well as the fixed assets and fixed liabilities; also the placing of goodwill so that it may be mentally deducted from the capital and surplus to determine the net value of tangible assets.

445. What difference exists between the receipt of revenues of a street railway and of an electric light and power company and how does this affect the auditor's work? Rule up a tabular form of customers' ledger for an electric light and power company illustrating the use of various widths of sheets in the same book.

446. What special attention should an auditor give to the sales of appliances of electric companies?

447. What is said of the depreciation rates for electrical equipment? Mention the most important features of a gas company audit and explain how you would deal with each.

449. Wherein do the charges for service of a water company differ from those of gas or electric companies and how does this affect the auditor's work?

450. What are the principal items of expense of a telephone company?

451. Mention the principal sources of income of a telephone company. What are the principal points, in the audit of a telephone company, that requires the attention of the auditor and how should he deal with each?

452. Draft a tabular form of customers' ledger for the use of a telephone company and explain how it

should be operated in connection with the general books.

453. Give a short resume of the instructions of the Railroad Commission of Wisconsin in reference to depreciation. Is a charge covering loss through contingencies such as extraordinary storms properly entered against the depreciation reserve?

## CHAPTER XXVI.

### SPECIAL POINTS IN DIFFERENT CLASSES OF AUDITS— MUNICIPAL—(Continued).

455. Explain how the budget of a municipality is prepared and also the manner of determining the tax rate.

456. Who are the principal financial officers of a city and what are their respective duties?

457. What are the principal sources of revenue of a city?

458. Of what value is "controlled financial stationery" and how is it used?

459. Mention a few advantages of periodical examinations of municipalities.

460. How would the auditor verify the taxes received and receivable? What attention do assessments require?

461. Is it in order for the auditor to verify outstanding accounts by correspondence? What are the principal classes of expenditure of a city and how would you verify each class?

462. Tell about the sinking fund provisions of most bond issues and the auditor's duty in regard thereto.

463. Give a list of the principal assets and liabilities of a city which would appear in the general fund balance sheet. What items constitute the capital



account balance sheet? Which would appear in the trust fund balance sheet? What is the purpose of the appropriation fund accounts and what does the fund balance sheet show?

464. What does the unpaid taxes account show? Is a reserve for bad debts necessary? What is the purpose of the stores account and how does it operate? How are stores, used for construction purposes, treated? Why is a reserve for stores, etc., set up on the books? Under what conditions is a "Temporary Loans" account necessary? What may the Capital Account Cash be used for and how is it obtained?

465. What is contained in the assessments receivable account? What does the Local Improvements in Progress account represent? Draft entries necessary when the improvements are completed. How are local improvements, chargeable against the city, treated? What is said in reference to depreciation of properties of a municipality?

466. What is the object of Special Improvement Bonds? How is the Sinking Fund Cash shown in the balance sheet? Explain how the Trust Funds are operated, giving consideration to each of the accounts used.

467. Give the headings for a satisfactory classification of accounts of a municipality. Into what two classes may the funds of a city be divided?

468. Draft entry necessary to place the budget appropriation on the books. How are the appropriation accounts treated when an expenditure is made or contracted?

469. Explain how the Available Balance and the Unapplied Balance accounts are operated. What does the Reserve for Retirement of Loans in Anticipation of Collection of Taxes represent?



470. Explain how funds raised by issuing bonds are treated, telling how the Reserve for Retirement of Assessment Bonds account is operated. Why are the accounts "available balance" and "unapplied balance" omitted from the consolidated balance sheet? What constitutes the surplus?

## CHAPTER XXVII.

### SPECIAL POINTS IN DIFFERENT CLASSES OF AUDITS, (Continued)—EXECUTORS AND TRUSTEES.

475. What are the first steps an auditor should take in auditing the accounts of an executor? How should the auditor proceed in verifying the income from securities and what should he require as to their registration?

476. Explain the steps the auditor should take in verifying the amount of commission claimed by the executor.

477. How should interests and rents accrued to the date of testator's decease be apportioned? How should profits sustained through the liquidation of investments be apportioned? How would you deal with (a) ordinary expenses; (b) repairs to income producing property; (c) losses on unauthorized investments; (d) income derived from investments in wasting assets; (e) funds appropriated by the trustee for his own use? How should premium or discount on bonds purchased be treated?

478. Explain the procedure where there are minor heirs.

479. Mention the most important points in the audit of an educational institution and explain how you would deal with each. Mention the most impor-

tant points in the audit of a charitable institution and explain how you would deal with each.

484. What is said of the audit of the accounts of churches?

485. Explain how you would audit the accounts of a club, also state how you would suggest that their transactions be recorded.

487. How would you proceed in the verification of commission and fees of an architect? Explain how the unfinished work of an architect should be valued.

488. What items require particular attention in the audit of the accounts of a doctor?

489. Explain how the accounts of an attorney should be kept.

490. Explain how the accounts of a contractor should be kept. How would you deal with payrolls? Explain how you would proceed in the valuation of work in progress for the purpose of determining profit.

492. What special points require consideration where there are a number of sub-contractors? What are the principal points in the audit of the accounts of a real estate concern and how should the auditor verify each item?

493. Explain how the cashier mentioned operated the accounts to cover his defalcation.

495. What are the books used by a land and development company, and explain the purpose and use of each. Give a short review of the work that should be performed by the auditor in auditing such a concern.

496. How would you proceed in the audit of a hotel and a restaurant?

497. What points require special consideration in the audit of an advertising agency and how would you deal with each?

498. How should the accounts of a theatre be kept? Tell how the auditor should verify them.

500. What is said of the audit of the accounts of a theatrical company?

## CHAPTER XXVIII.

### INVESTIGATIONS.

502. Distinguish between an audit and an investigation. Under what conditions is an investigation necessary?

503. Mention a few reasons why it is necessary to retain all working papers.

505. Explain how the auditor should act in reference to the assets that have been appraised.

506. Explain how the auditor should deal with entries that he believes to be fictitious.

507. Under what conditions may loose leaf records be admitted as evidence? What is said about erasures? What advantages accrue through retaining all original records?

509. Tell how an auditor may be of value to his client in an examination and give a short outline of the information he might convey with this purpose in view.

511. What period is usually covered in an investigation made to determine the sale value of a concern?

512. Of what importance is a careful report on Gross Earnings?

514. What features should a properly prepared statement for a prospective purchaser show?

515. What are the more common methods of manipulating sales? Tell how you would guard against them.

516. Of what value to the auditor would be an inquiry into the number of new accounts? Why would a month of unusually large sales require special mention in a report?

517. Explain the meaning of "turnover." (See "Accounting Principles.") In a report prepared to show the condition of a business to a prospective purchaser, how would you deal with profits due to the sale of a portion of the raw material? As an auditor, are you justified in charging a loss, due to an unfavorable fluctuation in the value of raw material, against earnings? To what extent is the auditor interested in the volume of expenses?

518. The expenditures of a magazine company during the first years of its life are in the nature of a purchase of goodwill. Should any charge be made against operations to absorb this expenditure? Explain how the auditor should deal with a lease, the first term of which will shortly expire and which may be renewed at a considerable increase of rental.

519. What other points in connection with leases require attention?

520. In the sale of a certain business it is decided to take over the stock at 10% below market. Explain how this deduction affects the earnings of the concern for the period under review.

521. To what extent is an auditor justified in certifying to future results?

522. Explain how the auditor should deal with prospective profits due to increased capacity or the ability to secure cash discounts.

524. In the case of a proposed consolidation, of what importance is the attitude of former owner?

526. What is said in reference to the preparation of a new system?



## CHAPTER XXIX.

## INVESTIGATIONS (Continued).

528. Explain how the auditor should deal with the income from assets that are not to be taken over at the time of sale.

529. Explain how you would deal with profits due to: (a) the sale of fixed assets; (b) the appreciation of assets; (c) insurance or the collection of damages to property in excess of actual losses.

530. Would you give effect to losses through defalcation or fire?

531. Why is it necessary to include a charge for management when determining profits even though no such expenditure has ever been made. How would you deal with existing contracts covering the purchase of raw material in advance of consumption?

532. Why should the auditor make enquiries into the requirements of the Public Service Commission?

533. To what extent should the auditor guard against errors in the books?

535. Is a liquidating partner entitled to compensation for his own services in closing out the concern? What consideration should the auditor give to discounts, allowances and credits for returned goods?

536. How should stock be valued at the time of a transfer of ownership? How should profits or losses on existing contracts be apportioned between retiring and continuing partners?

538. Give a short resume of the quotation from the paper on Accounting Practice and Procedure.

539. Mention the most important features of interest to bankers in connection with loans.

542. What is said in reference to an investigation for purely credit purposes? In answering this ques-



tion give consideration to (a) business methods of borrower; (b) causes of failures; (c) necessity of considering gross profit on sales; (d) insurance; (e) errors of principle.

549. Give a short outline of the auditor's procedure where he is endeavoring to locate a defalcation.

550. Should he allow the defaulter to assist?

551. Tell about the Millwall Dock case.

## CHAPTER XXX.

### HOLDING COMPANIES.

554. What information should the balance sheet of a holding company convey?

555. How should the excess of purchase price over book value be dealt with? When preparing a consolidated balance sheet, is an auditor justified in including with the surplus of the holding company, the surplus shown on the balance sheets of the subsidiary company? (See "Accounting Principles.")

556. In preparing a consolidated balance sheet how should inter-company transactions be treated? What is said in reference to accounts receivable?

557. Explain how the net profit of a holding company should be ascertained. (See "Accounting Principles.") Are profits of subsidiary companies not distributed as dividends by the subsidiary company available for distribution as dividends on the stock of the holding company?

560. Explain how interest on bonds of a subsidiary company in possession of the holding company should be treated in a consolidated statement.

561. Give a reason for including interest on plant investment when preparing comparative statements of several subsidiary companies.

## CHAPTER XXXI.

## INTEREST.

564. What is the rule of applying payments where partial payments are made and where principal and accrued interest are due? Is there a different rule where the payment is not sufficient to cover the accrued interest?

565. What is the law in respect to interest on a contract made in one place but payable in another? What is the rule in regard to changes in the law during the time a note is in force?

566. What is the custom of bankers in regard to interest?

567. Wherein does the custom of business houses and brokers differ from that of banks?

568. What is said in regard to the manner of computing the interest where a note runs a certain number of months and days?

## CHAPTER XXXII.

## THE LIABILITIES OF AUDITORS.

571. What is said in reference to increasing the responsibility of auditors?

573. What is the status of an auditor in England and what are his rights and duties?

574. To what extent is the auditor liable for the accuracy of his reports?

578. To what extent is an auditor responsible for the accuracy of inventories?

580. Under what conditions have the English courts held an auditor responsible for dividends paid out of capital?

585. In the case of the Irish Woolen Co., upon what grounds was the auditor held responsible?

587. Under what conditions is an auditor responsible for failure to detect embezzlement?

588. Give a short summary of the text covering the liabilities of auditors.

## CHAPTER XXXIII.

### THE LIABILITIES OF DIRECTORS.

593. What is said in reference to the compensation of directors and the auditor's duty in reference thereto?

594. Under what conditions may a director have access to the books of the company? Give a short summary of the American Malting Company case and the liability of the directors thereof.

## AUDITING EXAMINATION QUESTIONS

### UNIVERSITY OF THE STATE OF NEW YORK 34TH ACCOUNTANT EXAMINATION

#### GROUP I

1. The bondholders of a company are contemplating an action against the directors and retain you to obtain the accounting proof of their contentions; subsequently the directors ask you to act in the same capacity for them; they profess to have no objections to your representing both sides. What would you do?

2. Explain the steps you would take regarding an asset described as "Accounts Receivable—Suspense," in the audit of a business, the owners of which required a "clean and unqualified certificate."

3. In an audit of a business the Plant Account of which has been increased from \$100,000 to \$150,000, what steps would you take regarding this asset and what would be your controlling consideration as to the propriety of the \$50,000 of additions during the period under audit?

4. What vouchers would you refuse to accept in the audit of a corporation, even though such vouchers were duly approved by such of the officers of the corporation as is required by custom or in the by-laws? Give examples and explain.

5. A life insurance company pays lump sum of \$7,500 to purchase an agent's interest in renewal premiums. What is the correct treatment of such expenditure? Explain fully.

#### GROUP II

6. A lead company issues certificates evidencing the sale of and agreement to deliver on demand to the purchaser a certain number of pigs of lead of variable and unknown weight, at a price to be based on the average daily published quotation of pig lead during the month in which the certificates are issued. In a certified balance sheet how would you treat these certificates? Explain.

7. In an audit covering the year ended December 31, you discover that invoices aggregating \$2,000 for bricks and other building materials to be used in the construction of an addition to the plant, were received after the books were closed, although the materials were actually received on December 15. As the materials were not taken into the inventory and the invoices were not on the books, would you require any adjustment? Give reasons.

8. As a certified public accountant auditing the books of a manufacturing business that operated a supposedly highly developed cost system, what steps would you take regarding inventory values that were found to agree with the cost records?

9. You are instructed to make an audit, prepare and certify a balance sheet to be publicly used in the sale of additional capital stock. The date of your engagement is September 16, 1912. No



inventory has been taken since October 31, 1911. What course would you pursue?

10. The Wiltshire Life Insurance Company's office building has suffered a total loss by fire. The loss stands on the books at \$100,000 but the site alone is known to be worth double that amount. At the time of your audit the company has lost in rentals from the burned building \$6,000 and has paid \$15,000 taxes and expenses incidental to the removal of debris. How would you have these items treated? Give reasons.

### GROUP III

11. Write *three* concise certificates to a balance sheet, with qualifications respectively as to (a) inventory of merchandise not taken under your supervision, (b) accounts receivable not verified by confirmation, (c) investment securities not examined.

12. The "proof" of the first teller of a bank shows the following captions:

*Debits* (1) Cash, (2) Second Teller, (3) Third Teller, (4) Second Teller Special, (5) Clearing House.

*Credits* (1) National Bank Notes, (2) Checks on Bank, (3) Second Teller's Items, (4) Third Teller's Items, (5) Clearing House.

State what instructions you would give to an assistant whom you were about to entrust with the checking of that proof, immediately following the count of the cash and securities on hand.

13. You are retained by an inventor to ascertain the accuracy of the figures submitted by a company operating under his license. Royalties are paid on sales; licensee issues a catalog in which the sundry finished products are referred to by numbers; if the invention is used on any particular product the letter I precedes the code number. What steps would you take to perform your duty?

14. An electric lamp manufacturing company has charged to cost of lamps as "depreciation" one-fourth of the value of the filament-filtering machinery acquired a little more than one year ago. The life of the machinery is estimated to be 10 years, but owing to discovery by a competitor of a new process of metal pulling which, while still imperfect, promises to revolutionize the lamp industry, the machinery in question will probably be obsolete within a period of three years. State at length what you would say concerning the propriety of making such a charge to cost.

15. The consolidation of companies A, B, and C is under consideration; it is desired to establish a comparative statement of income for the three companies as of August 31, 1912. Company A closes its books on December 31; Company B on June 30; the fiscal period of Company C expired on August 31. No inventories have been taken as of the latter date by A and B, and they will not be taken. Express the procedure that you would follow in order to establish a satisfactory statement.

UNIVERSITY OF THE STATE OF NEW YORK  
35TH ACCOUNTANT EXAMINATION

## GROUP I

1. A, engaged in the jobbing business, enters into a copartnership agreement with B, the terms of which are in substance as follows: B is to share in the gains and losses of the business at the ratio of  $37\frac{1}{2}\%$ , which is in proportion to his investment of \$6,000. A is to act as general manager, cashier, etc., and is to render an accounting to B at the end of every six months. The books are kept by single entry. They are day book, check book, provided with proper columns and space for deposits, drawings and particulars, and a general ledger kept in accordance with the purpose of single entry. All moneys received or paid pass through the bank. You are engaged to render the accounting to B at the end of the first six months. State what information you would consider necessary to convey to B, and how you would proceed to obtain it from the material at hand.

2. What are the chief points to which attention should be directed in dealing with fluctuating currency in the books of accounts of merchants?

3. An auditor, on completing an investigation of the affairs of an importing house, certifies that the accounts are correct as recorded in the books. Would you criticize this certification? If so, why?

4. An importer of automobiles receives shipments in accordance with *bona fide* orders placed against six months' acceptances with interest. He stores the merchandise in bonded warehouses subject to withdrawal. At the end of the fiscal period it is customary to omit from the inventory such warehouse goods as are left and also the acceptances unpaid. In being asked to certify the statement of conditions at a given time, how would you deal with this state of facts?

5. A, B and C are equal partners, each having subscribed \$5,000 to the partnership. A pays in \$3,000, leaving \$2,000 still due the partnership on his capital account. It is agreed for the present that this \$2,000 can remain unpaid, provided A pays interest on same, which he does. Later a dispute arises as to how this interest shall be credited. A claims that it should be included with the earnings of the business, the profits of which are to be divided equally among the three partners. B and C claim that this interest should be divided between them only, as they have fully lived up to their obligations under the partnership agreement, while A had only partially done so. To what account should the interest on the deferred payment be credited?

## GROUP II

6. In auditing the accounts of a manufacturing firm, what salient features of the cost ledger should receive attention?

7. In auditing the accounts of a manufacturing contractor, what manipulations of the cost accounts should the auditor anticipate, to guard against inflating profits?

8. What common expedient is resorted to by manufacturing contractors to hide their losses in the cost ledger?

9. In auditing the accounts of a factor, what equitable method should the auditor employ to ascertain the amount of interest due to or from the consignor with respect to the account sales?

10. What documentary evidence would you require to prove the acceptance of bills payable by a factor, against goods in transit?

### GROUP III

11. What method would you adopt to prove the outstanding certificates of stock to be correct as represented on the transfer ledger?

12. The value of the lease of a piece of property for 20 years, with privilege of renewal for a like period, is carried on the books at its value in fee simple. Would you pass this unnoticed? If not, why not?

13. In the books of a manufacturing corporation whose accounts you are investigating for creditors, you learn from outside sources that accounts assigned to a discount company have been concealed. Explain how this may have been done and the methods you would pursue to detect it.

14. Three corporations are to be merged. In examining the records of Corporation B formed three years previously with an authorized capitalization of \$250,000, you find the entire capital stock carried on the books as fully paid in. The facts you ascertain are as follows:

There are three directors, X, Y and Z, composing all the subscribers to the stock. The payments have been received at a directors' meeting with all present. X subscribed for \$100,000 worth of stock and paid all in cash; Y subscribed for \$75,000 worth of stock and paid \$50,000 in cash and a note of \$25,000 on demand; Z subscribed for \$75,000 worth of stock and paid \$25,000 in cash and a note of \$50,000 on demand.

These notes are carried among the assets and are still unpaid at the time of your examination, no interest having been collected. Y and Z cannot make good. In preparing a report on this state of facts what recommendations would you make and why?

15. In auditing the books of a concern you detect the following:

A customer paid \$100 in currency on account of a debt and returned \$10 worth of merchandise. The entry in the cashbook records a receipt of only \$90 and the return book a return of \$20. The money not properly accounted for was taken by the book-keeper. In reporting these facts state where in this transaction you find a defalcation, a fraud committed or an embezzlement.









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